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SUBJECT: ESTONIA'S NEW GOVERNMENT (PART IV): DOMESTIC AND ECONOMIC POLICY PRIORITIES

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Classified By: CDA Jeff Goldstein for reasons 1.4 (b) & (d).

¶1. (SBU) Summary. As reported in reftels, On April 4, 2007, the Estonian Reform Party formed a center-right coalition with the Isamaa-Res Publica Union (IRL) and the Social Democrats (SDE). The new government has four key domestic policy priorities: tax cuts, innovation, bolstering the workforce, and enhancing energy security. The government intends to:

-- Cut personal and corporate income tax from 22% to 18% by 2011;
-- Find a technical fix to address EU concerns while maintaining the policy of not taxing reinvested corporate income;
-- Increase the budget for education and for R&D so as to make the economy more competitive over the longer-term;
-- Address workforce constraints by increasing funding to promote Estonia's incipient baby boom and lure back Estonians who have emigrated; and
-- Improve energy security by investing in upgraded power plants and "green" technology, participating in the project to build a new generation nuclear plant in Lithuania and in projects to link the Baltics with the EU energy grid. End Summary.

Tax Cuts, Tax Policy and the Euro

¶2. (U) The centerpiece of the government's domestic agenda is its ambitious tax cut plan. The coalition agreement commits the government to reduce the flat income tax rate from 22% to 18% by 2011. As its number one campaign priority, the Reform Party pushed through the tax cuts in coalition negotiations, justifying them as essential to ensuring economic growth and keeping the economy competitive. To allay public fears that tax cuts would create a budget deficit, the government has pledged that the cuts will be done in the context of a strict policy that adheres to its goals for maintaining a surplus (currently 3.8% of GDP) and reducing government debt (currently 3.7% of GDP).

¶3. (C) Although they accepted Reform's tax cuts, SDE and IRL interlocutors have expressed their parties' concerns with the proposed plan. Unlike Reform, which predicts economic growth falling no lower than 6%, IRL and SDE worry that if the economy slows down faster than expected, the government will not be able to afford the necessary infrastructure or social and educational investment the country needs. As SDE Secretary General Randel Lants put it, "Reform's tax cuts may well eat up half our budget." SDE leaders tried unsuccessfully to peg the tax cuts to economic growth indicators during coalition negotiations. If the economy fares worse than expected, SDE interlocutors

have told us they will reintroduce these measures.

¶4. (SBU) Inflation rates higher than the Maastricht target forced Estonia last year to postpone the hoped-for adoption of the Euro until 2010 or beyond. Critics have opined in the press that the government's tax cuts will only exacerbate inflation, making it more difficult to adopt the Euro. The government's coalition agreement does make transition to the Euro a priority, but it is short on details. One high-ranking Reform official summed it up by telling us off-the-record, "Economic growth is more important than the Euro."

¶5. (SBU) The new GOE also appears to have settled on a long-awaited solution to the dilemma of how it will reconcile Estonia's signature policy of zero tax on reinvested corporate profits with an EU mandate that would also require zero tax on profits distributed to EU parent companies. PM Ansip recently announced that Estonia will allow the creation of "reserve accounts" into which corporate profits can be paid. While Ansip committed to preserving the zero tax on reinvested profits, working-level contacts we have spoken to indicate there may be a provision for taxing funds that are put into these reserve accounts, without calling them either dividends or retained earnings. Ansip has also committed publicly to maintaining the kroon's current peg to the Euro at 15.64, rejecting speculation about a possible devaluation of the currency.

Improving Education, Innovation and R & D:

¶6. (U) The flip side of Estonia's strong economic growth in recent years has been a marked rise in wages, leading to an

erosion of competitiveness. All three parties agree that the government needs to improve Estonia's productivity, and re-orient the economy to higher-value manufacturing and services in order to ensure sustainable economic growth in the face of global competition. The most commonly cited strategies for doing so focus on turning out more scientists and engineers, and spurring innovation as well as research and development.

¶7. (SBU) The GOE sees education as central to improving Estonia's competitiveness. Although it doesn't give a precise figure, the agreement pledges to increase the education budget annually by "at least the same pace as the average growth of budgetary expenditure." Priority will be given to improving school infrastructure, raising teacher salaries, and modernizing the curriculum through information technology across the board (e.g., primary, secondary, and vocational schools). Government interlocutors have told us that their objective is twofold: to ensure high quality programs that are available for everyone, and reduce the growing educational and digital gap in the country. Despite all the positive press on "E-stonia" in foreign papers, IRL Member of Parliament Ott Lumi said that the educational and digital divide between both urban and rural communities, as well as Estonian and Russian-speaking communities, was only worsening. Lumi noted that Estonia's mid-to-long term economic future depended on the government's success in bridging this divide.

¶8. (U) In addition to improving education, the government will considerably increase spending on research and development (R&D). The GOE is clear that spending the Lisbon Agenda goal of 3% of GDP on R&D right now would be a waste of money until more scientists and institutions are in place to absorb this funding and put it to good use. Currently, the Ministry of Economic Affairs and Communication (MOE) estimates that roughly 400 enterprises in Estonia (0.5% of all enterprises) are investing in R&D - and many of these are quite small. The MOE's goal is to

spend 2% of the GDP on R&D by 2011 and, ultimately, 3% by ¶2015. The basic outline of their approach is to identify Estonian firms and institutions with competency in three key technologies: biotech, information technology, and materials. A combination of state-run bodies (such as MOE and Enterprise Estonia) and private venture-capital firms (such as the newly formed Development Fund) will then direct EU structural funds and equity investment capital to these firms and institutions.

Workforce and Population

¶9. (U) A third domestic priority for the governing coalition is the tight labor market, especially in services and construction. (Ref A) Because of the already sizeable Russian-speaking minority (approximately 37% of the population), and a history of forced migration during Soviet times, the coalition believes that large-scale immigration from non-EU countries is politically unacceptable as a solution to the shortage of workers. Instead, the GOE plans to promote indigenous population growth by increasing maternity/paternity leave and benefits, providing higher incentive payments to parents who have a third or fourth child, offering subsidized day care and health care for children, and developing flex-time and tele-working for working parents. The Ministry of Population also recently announced the creation of a position for coordinating the return of Estonians from abroad, estimated to be approximately 32,000 (5% of the workforce) since EU accession. While mass immigration is not an option for the government, it does plan to offer financial assistance in hiring highly qualified specialists from third countries for short-term projects for Estonian enterprises, mainly for product development (e.g., software programmers, etc.).

Energy Security

¶10. (U) The final priority for the new government is in the area of energy security. In this arena, the government is moving ahead with a number of initiatives. These include continuing ongoing upgrades to the country's primary source of electricity, the Narva Oil Shale Power Plants. Estonia is also setting targets for greater use of biofuels and other renewables over the next five years and building a liquefied natural gas (LNG) terminal at the port of Sillamae. But their primary energy security initiative is a partnership with Latvia, Lithuania, and now Poland to construct a new nuclear power plant at Ignalina, Lithuania

(Ref B).

¶11. (SBU) The GOE's goal for energy security, beyond providing Estonia with alternate sources of electricity, is to complete the circle begun with the Estlink power cable to Finland by connecting the Baltic grid with Western Europe's grid, the Union for the Coordination and Transmission of Electricity (UCTE).

¶12. (SBU) Comment. Negotiations over the new GOE's domestic policy priorities were settled relatively quickly and amicably. What continues to hover over all these ongoing discussions is the extent to which Reform's tax cuts may limit the government's social agenda. If economic growth slows down, IRL and SDE will likely hold Reform responsible for any social cut backs. End Comment.
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